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In the Supreme Court of the United States

OCTOBER TERM, 1940.

No. 121.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER.

v.

NORTHWEST STEEL ROLLING MILLS, INC.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Ninth Circuit.

BRIEF FOR APPELLEE, NORTHWEST STEEL ROLLING MILLS, INC.

SUPERIOR PRINTING COMPANY · SEATTLE

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BRIEF FOR APPELLEE, NORTHWEST STEEL ROLLING MILLS, INC.

OPINIONS BELOW.

Board of Tax Appeals—(R. 16-18); (unreported); *Circuit Court of Appeals*—(R. 77-85); 110 Fed. (2d) 286.

JURISDICTION.

As this is written the petition for writ of certiorari has not been granted. If the petition is granted, jurisdiction will rest on Sec. 240 (a), *Judicial Code,* as amended by Act of February 13, 1925.

STATEMENT.

Appellant claimed that under §14, Revenue Act of 1936 (Appendix), surtax on *undistributed profits* should be imposed on Appellee for the year 1936, and determined a deficiency of $13,628.22. Appellee denied that *any* such tax was proper, asserting a credit based on §26 (c) (1) (Appendix) to the extent of the undistributed profits because of contracts restricting payment of dividends.

The Board of Tax Appeals denied the credit upon the authority of the Board's previous decision in the *Crane-Johnson* case. The Board's decision was reversed by the Circuit Court of Appeals (9) which allowed the credit and held that Appellee's charter is a contract within the meaning of §26 (c) (1), and that Appellee had proved it is entitled to the credit and was restrained by its Charter from distributing a dividend in 1936.

Appellee was incorporated in Washington State in 1926, and its place of business was and is in Seattle (R. 14). Its articles of incorporation provide in part:

> "That the purposes and objects for which this corporation are formed are: * * *
>
> "Nineteenth. To exercise such powers as are or may be granted or conferred by the general incorporation laws of the State of Washington. * * * " (R. 58, 63; Exh. 3).

Pertinent State laws binding on Appellee with respect to dividends are set forth in the Appendix.

These laws prohibit dividends unless *actual* surplus of assets over liabilities exists. While Appellee had a surplus by *appraisal,* there is no evidence that there was an *actual* surplus at any time.

Mr. Goetz, who had been general manager of Appellee continuously from January 2, 1934, testified that there was never a time within his knowledge when appellee was in a position to pay a dividend (R. 50). *This testimony is uncontroverted.* Appellee had a deficit continuously from 1926, when it was incorporated, until 1936 (R. 50). This deficit had been steadily accumulating (R. 50). As of the close of 1935, the deficit was $76,983.26 (R. 14, 71). Net income for 1936 was $76,049.71 (R. 14), or less than the deficit existing at the end of the preceding year, leaving a deficit at the end of 1936.

In 1926, Appellee had borrowed $150,000 from a Seattle bank (R. 38, 15). In 1935 it owed, on ninety day note, $115,000, at which time the bank required payment of $1,000 a month (R. 38, 39, 49, 15). The bank had been criticized by the Bank Examiner because of the amount of the indebtedness (R. 39, 15), and the executive committee of the bank was seriously concerned about the loan (R. 39, 15). Verbally the bank and Appellee agreed that all funds above operating costs would be used to reduce the loan (R. 41, 46, 47) and payment of a dividend was prohibited (R. 41). Appellee was in danger of receivership if it violated the bank's instructions (R. 41). The note was paid July 6, 1936, balance then being $85,000 (R. 49, 15), the payment being made from reduction of inventories (R. 50).

SUMMARY OF ARGUMENT.

A. Appellee should be allowed credit for contracts restricting distribution of dividends under Section 26 (c) (1), Rev. Act of 1936, because

1. Appellee was prohibited by the laws of the State of Washington from distributing a dividend in 1936 due to an existing deficit.
2. Laws of the State of Washington so prohibiting the distribution of dividends are a part of Appellee's charter.
3. The charter is a "written contract,"
4. "Executed by the corporation prior to May 1, 1936."
5. Appellee's charter expressly deals with distribution of dividends.
6. Interpretation of Section 26 (c) (1) to allow the credit conforms with rules of construction.
   (a) Any other construction would result in discrimination against "deficit" corporations prohibited by charter from distributing dividends.
   (b) A constructon is to be avoided which will raise doubt as to the constitutionality of the Act.
   (c) Doubts must be resolved in favor of taxpayer.
   (d) Relief provisions are to be liberally construed.
   (e) Administrative construction to the effect that a charter does not constitute a written contract within the meaning of the Act has not received Congres-

sional approval by re-enactment of the statute, is contrary to judicial precedent, unreasonable and invalid.

(f) Administrative construction in other respects supports Appellee's position.

7. Legislative history is consistent with Appellee's position.
8. Stock certificate is a contract within Section 26 (c) (1).

B. If the Act is construed to disallow the credit, when applied to Appellee it is unconstitutional as:

1. Arbitrary and discriminatory in violation of the Fifth Amendment to the Federal Constitution;
2. An invasion by the Federal Government of the powers delegated to the states to regulate corporations, in contravention of the Tenth Amendment;
3. Outside the power to tax authorized by the Sixteenth Amendment, and the tax is not apportioned.

A.

In order for the credit to be available there must be a written contract. This contract so long as it is in writing, need be of no particular type or classification. It may be private or public. Under the well established judicial rule that a corporate charter is a contract, and in the absence of specific exclusion of charters by the Act, the word "contract" embraces a corporate charter. Likewise, it embraces the stock certificate.

State incorporation laws are held by concert of judicial opinion to be *part* of the charter. So emphatic is this rule that if there is conflict between the incorporation laws and other language of the articles of incorporation the laws prevail. The incorporation laws are by *express reference* in the articles *and* by operation of law, made a part of the charter of Appellee. Such laws are held to be *provisions* of the charter as much as if written in the articles verbatim.

The state incorporation laws prohibited Appellee from paying a dividend in 1936 because of Appellee's deficit, and also prohibited the trustees from paying a dividend. A dividend if paid would have been illegal. These laws being part of the charter constituted a basic part of the contract between Appellee, the State and the stockholders. The laws *expressly* prohibit the *corporation* from paying a dividend while a deficit exists. That Appellee could not have paid a dividend is uncontroverted in the evidence. Thus under basic conditions and provisions of the charter, Appellee was expressly prohibited from paying a dividend.

The words "executed by the corporation prior to May 1, 1936," refer to *time* rather than *manner*. This portion of the statute is designed to limit the time beyond which contracts, though effective and binding, will be available to taxpayer for the credit. The intent is that if prior to May 1, 1936, a written contract binding on the corporation is in effect, this portion of the statute has been complied with. Appellee's charter was effective in 1926.

If "executed" refers to *manner* of entering into

the contract, the word is broader in meaning than "to sign." To execute a contract requires a meeting of minds and a completion of all things necessary to make the contract binding. Acceptance may be through an agent. Under the law of Washington State there is practically identity between incorporators and corporations. Also under Washington law ratification of the incorporators' acts by the corporation is a recognized principle. The charter was fully executed by Appellee in 1926 under either a time or manner interpretation of the statutory language.

The interpretation of the Circuit Court (9th) is consistent with rules of construction. Doubts should be resolved in favor of taxpayer. 26 (c) (1) is a relief provision and should be construed liberally. The construction contended for by Appellant would lead to an unjust result in that deficit corporations in 12 states could distribute dividends and obtain credit, while those in 36 states can not distribute without violating state laws. An act should not be construed to obtain a flagrantly absurd result. The purpose of the law should be kept in mind. It was to require distribution of *surplus*. Where no surplus exists, the reason for the requirement ceases.

Legislative history, while of littie help generally due to difference in the bills before House and Senate, indicates that the word "executed" had no technical import but meant "entered into" or "in existence."

Practical considerations weigh heavily in Appellee's favor. Under Appellant's contention, Appellee would have to pay the Federal Government in excess

of $13,000 because the State Government prohibits it from distributing a dividend as a matter of public policy. Placing the tax on undistributed net income was designed to persuade or compel distribution to shareholders. Such persuasion or compulsion runs squarely against State law in Appellee's case. The bureau is conclusively presumed to know the provisions of the charter. It is constantly in touch with corporation affairs and could as easily determine the facts under a public contract (the Charter) as under a private contract.

Congress admittedly, in 1938, recognized the injustice of the results of this law *as administered under the Treasury Regulations* and provided appropriate remedy. The Treasury Regulation is not binding upon the Courts and is contrary to well settled judicial precedent.

B.

If construed as not including a credit to Appellee, the Act is unconstitutional because it arbitrarily discriminates between a charter and other written contracts; between oral and written contracts; between deficit corporations able to pay a dividend and those not able to do so because of state law; and between deficit corporations and other corporations because it is doubtful, at least, whether a distribution by a deficit corporation to a stockholder would result in a taxable dividend in the hands of the stockholder, and if it did not then the corporation could not obtain a dividend paid credit under the Act, whereas other corporations distributing surplus could obtain such dividend paid credit.

Further, if so construed, the Act induces and is

intended to induce distributions despite state regulations. The states have exclusive regulatory power over corporations. Dividends are an important matter to stockholders and creditors. Their restriction is public policy. The inducement in the Act here considered is not necessary as an incident to taxation.

Also, the tax as to deficit corporations can not be on income but is on capital until impairment of capital has been restored. The tax is not apportioned. It does not come within the Sixteenth Amendment.

ARGUMENT.

I.

Appellee Was Prohibited by the Laws of the State of Washington From Declaring or Distributing a Dividend in the Tax Year of 1936 Because of an Existing Deficit.

A. *State Laws.*

Section 1, Article XII of the Constitution of the State of Washington provides:

> "Corporations may be formed under general laws, but shall not be created by special acts. All laws relating to corporations may be altered, amended, or repealed by the legislature at any time, *and all corporations doing business in this state may, as to such business, be regulated, limited or restrained by law.*" (Italics supplied.)

Appellee was organized as a corporation under the laws of the State of Washington in 1926 (R. 14, Exh. 3, Art. of Inc.; R. 58-66, Exh. 4; R. 67).

Article II, Section 19 of the Articles of Incorporation expressly refers to the incorporation laws (R. 63).

The laws of the State of Washington prohibit a *corporation* from paying dividends unless there is a surplus of the aggregate of assets over the aggregate of liabilities, including in the latter the amount of the corporation's capital stock, and that surplus must be *real* and *actual* and not simply a book entry. *Uniform Business Corporation Act,* Laws of 1933, p. 785, §24, State of Washington; *Rem. Rev. Stat.* 3803-24 (3, 4, 5), quoted in Appendix.

The State statute further gives *to the corporation* a right of action against the directors and the shareholders in the event of a violation of the section above quoted (*Appendix, Rem. Rev. Stat.* 3803-25).

It is *unlawful* for the trustees of a corporation to

> "Make any dividend except from the net profits arising from the business of the corporation"

and it is *unlawful* to divide, withdraw or in any way pay to the stockholders, or any of them, any part of the capital stock of the company. *Rem. Rev. Stat.* 3823, Laws of 1923, p. 543, §2 (Appendix). See *State ex rel. Washington etc. Co. v. Murray,* 181 Wash. 27, 37, 38; 42 Pac. (2d) 429 (1935).

The rule in the State of Washington, adopted long prior to 1926 and followed uniformly, is that capital stock is a trust fund for payment of corporate debts and must not be impaired by distributions to stockholders, and solvency of the corporation is immaterial. *Brenneman v. Whitehouse,* 85 Wash. 355, 358, 359; 148 Pac. 24 (1915).

> "While the company is solvent, the dividend receiving stockholder can be compelled to return the dividends received by him, if paid out of capital, irrespective of whether or not those dividends are necessary to satisfy the company's liabilities." *Gaunce v. Schoder,* 145 Wash. 604, 610; 261 Pac. 393.

Dividends paid in impairment of capital of the corporation are "illegal." *Sparling v. Gen. Discount & Mtge. Corp.,* 178 Wash. 663, 670, 35 Pac. (2d) 60; affirmed on rehearing 184 Wash. 387, 50 Pac. (2d) 1023.

In the *Sparling* case, the Court cited with approval *Jorguson v. Apex Gold Mine Co.,* 74 Wash. 243, 133 Pac. 465, 46 L. R. A. n. s. 637, in which the rule was enforced to the extent that:

> "Any contract whereby a corporation seeks to diminish its capital stock, except in some way permissible by statute, *contravenes public policy* and is unenforcible."

Also cited was *Austin v. Wright,* 156 Wash. 24, 27, 286 Pac. 48, in which the opinion points out that the uniform rule applicable to corporations incorporated in the State of Washington is that the corporation:

> "Could only pay dividends out of profits"

and in the *Jorguson* case, *supra,* the Court stated:

> " 'The rule of law that requires corporations to preserve their capital intact is alone sufficient to prevent the corporation from paying dividends except out of profits.' 5. *Thompson, Corporations,* 2nd ed., §5305."

There are no "profits" which can be divided so long as there is a deficit. *Willcuts, Collr. v. Milton*

Dairy Co., 275 U. S. 215, 218, 72 Law Ed. 247, 248.

> "The rule is that a corporation does not have earnings or profits available for distribution as dividends until impairments of capital or paid in surplus resulting from operating losses have been restored. *Willcuts v. Milton Dairy Co.*, 275 U. S. 215; *Crystal Ice Co.*, 14 BTA 682; *Arthur C. Stipel*, 29 BTA 1145; *Louise Glassell Shorb*, 22 BTA 644; *Loren D. Sale*, 35 BTA 938. This rule is recognied by the Commissioner. G.C.M. 1552, C. B. VI—1, p. 10." *Kinnear v. Commr.*, 36 BTA 153, 155. *Foley Securities Co. v. Commr.*, 106 Fed. (2d) 731, 732, 733.

B. *Evidence of Deficit.*

Mr. Goetz, general manager of Appellee, testified that Appellee had *never* been in a position to make a dividend (R. 50). Appellee had sustained a deficit since its incorporation (R. 50). Appellee's precarious financial situation was a matter of concern to the lending bank and to the Bank Examiners (R. 15, 39). Any cash above operating expense had to be devoted to the bank loan which was paid off during 1936 by reduction of inventories (R. 15, 41, 46, 47, 49, 50). As Mr. Goetz phrased it, a deficit had been "accumulating right along" (R. 50). That Appellee could not pay a dividend is undisputed in the evidence.

Appellant argues that the testimony of inability to distribute dividends is limited to the period prior to the payment of the bank loan. But the word "ever" is used in the question relating to the inability of Appellee to pay a dividend. Appellant's contention requires the reading by implication into the question and answer the words "before July 6,

1936." It is plain that such meaning was not intended. Such meaning is inconsistent with the use of the word "ever." Further, the subjects are not necessarily related. The question limited in time related to the bank loan. The question unlimited in time referred to dividends.

Appellant contends that Goetz's testimony is a conclusion of law and as such is of no effect. This contention was first advanced by Appellant in the Circuit Court of Appeals. No objection was made before the Board. In arguments to the Board the issue was accepted as being whether the charter is a contract within §26 (c) and whether the Act was constitutional. The argument comes rather late on the evidentiary feature. The contention lacks merit.

> "In approaching the questions presented for our decision, we have in mind the elementary rule that issuable facts need not be shown by direct evidence, but may be arrived at by fair inference. We have in mind also the rule that parties have a right to try their case on evidence which is not of the quality and character required by the law, and where such evidence is admitted without objection, it is the right and duty of the court to give it the same consideration as if it were legal evidence." *Schanbacher, et al. v. Lucido Bros.*, 93 S. W. (2d) (Mo.) 1076, 1081.
>
> "Agency of this case is a question of law to be determined by the court upon the primary facts, and such facts only should have been elicited from the witness upon this point, and the answer of the witness states a legal conclusion and was incompetent. *Ford Motor Co.*

v. Levesay, 61 Okla. 231, 161 Pac. 901. This evidence was admitted however without objection and stands without any effort of the plaintiff to strike it from the records. When incompetent evidence is thus admitted it must be given its natural effect. This evidence therefore is sufficient to make a prima facie proof of agency * * * ." *Stanley v. Wilkinson,* 229 Pac. (Okla.) 574, 576.

The following cases also support the proposition that even assuming a witness testifies to a conclusion, if such testimony is admitted without objecton, it is of probative value. *Spicer, et al v. Henderson,* 43 S. W. (Texas) 27; *Sugerman, et al. v. Stelling, et al.,* 135 N. Y. Supp. 595; *Ridenhour v. Okla. Contracting Co.,* 45 S. W. (2d-Mo.) 108, 112; *Maine v. May Stern Furniture Co.,* 21 S. W. (2d-Mo.) 211, 213; *Wood v. Consolidated School Dist. No. 13,* 7 S. W. (2d-Mo.) 1018, 1021.

> "Parties have a right to try their case on evidence which is not of the quality or character required by law, and where such evidence is admitted without objection, it is the right and duty of the court or jury to give it the same consideration as if it were legal evidence." 23 C. J. 39, §1783, 'Evidence.' "

Consequently, assuming, which we do not concede, that the testimony of Mr. Goetz is only a conclusion, still it went in without objection and no attack was made upon it in the record. It was uncontroverted.

Had the Board refused to accept the testimony referred to, and which was uncontroverted, such refusal would have been error.

> "Since no evidence whatever was submitted for respondent, it was error wholly to ignore this testimony." *Belridge Oil Co. v. Commr.*, (CCA-9) 85 Fed. (2d) 762, 768.

Cases cited in support of the argument that the testimony is ineffective though admitted without objections are inapplicable. In *Walker v. McCloud*, 204 U. S. 302, 310, the testimony was that an Indian Chieftain had *ratified* a sheriff's sale, but the proof showed that the sale was conducted in violation of law and the witness testifying regarding the ratification stated that prior to the sale the Chief told him "to proceed according to law to dispose of the buildings * * *." This Court stated that it "would hardly be supposed that the Chief would at once ratify a violation of the law in the conduct of the sale." Thus, the witness' own testimony refuted ratification.

In *Parker Co. v. Commr.*, 49 F. (2d) 254, the charter of a corporation was not introduced in evidence. A witness stated that the corporation belonged to a certain legal classification. This was the statement of an opinion on a point of law. The Court, not having the charter before it, could not pass upon the question.

In *Pruett v. Midkiff*, 273 Ill. App. 142, the witness showed no familiarity with the financial condition of the corporation but testified that the corporation was insolvent..

In *Norfolk & W. Ry. Co. v. McCoy*, 257 Ky. 32, opinion evidence as to damage was unsupported by any facts. The Court remarked that "an earnest review of the testimony" of plaintiff's witnesses showed that the verdict "is flagrantly against the evidence."

In the instant case, Goetz was the manager and knew the company's condition. He testified to an accumulating deficit. Facts were proven as to the bank loan and the seriousness with which the bank and the Bank Examiner regarded the situation. That Appellee had never been in a position to pay a dividend is a statement of fact coming from the manager of the company. It would be so regarded if made to a stockholder. There is nothing in the record to refute it.

Appellant argues that the Goetz testimony is opinion evidence.

> "No rule applicable to all cases can be laid down as to what constitutes an opinion or conclusion as distinguished from a statement of fact. In determining the admissibility of evidence, it is more important to get the truth than to quibble over impractical distinctions between facts and conclusions." *Nichols,* "Applied Evidence," Vol. IV, p. 3399.

The "quibble" made in the Appellate Court comes after the evidence is in and there is less reason for its consideration than there would be if it had come in the form of an objection during the trial. In any event, the Goetz testmony did not go to a matter of interpretation of State law. The witness was presumed to know the statutory law. That law is unequivocal. The testimony relates to a factual situation, namely, inability to pay a dividend because of the financial position of the corporaton.

The Circuit Court's opinion on this phase of the case is amply sustained by the evidence. The minority opinion does not take issue with the majority's

conclusion that there was proof of the deficit and that dividends could not have been paid legally.

Determination of facts by the Court below which facts are not without substantial support in the evidence are accepted as unassailable. *Alabama Power Co. v. Ickes,* 302 U. S. 464, 476; *Paige v. Ark. Natural Gas Corp.,* 286 U. S. 269, 271; *In matter of Tax Service Assn. of Ill.,* 305 U. S. 160, 163; *Tex. & New Orleans R. R. Co. v. Brotherhood,* 281 U. S. 548, 558.

Appellant refers to surplus by *appraisal,* but concedes that the test under the law of the State of Washington is *actual* surplus. (See *Rem. Rev. Stat.,* 3803-24 (3).) This being so, whether surplus by appraisal existed is immaterial.

Appellant cites *Goodnow v .American Writing Paper Co.,* 73 N. J. Eq. 692, 69 Atl. 1014, and contends that a dividend may be declared out of profits even though the total assets of the company may not exceed its debts and the nominal share capital. This certainly is not the law in the State of Washington. However, under the New Jersey Act considered in that case, it was provided that the directors of a corporation shall not make dividends, except from surplus, *or from net profits* arising from the business of such corporation." The Court stated:

> "Although the change in language indicates that the Legislature made a distinction between surplus and net profits, it does not necessarily follow that *net profits* mean the difference between gross earnings and what may be called operating expenses. Such profits may be called annual profits, *and it may be that by net profits the Legislature meant the net profits upon the*

whole of the company's business from its organization."

The same term "net profits" is used in *Rem. Rev. Stat.* 3823 (Appendix) prohibiting trustees from making distribution "except from the net profits arising from the business of the corporation." If the reasoning of the *Goodnow* case is applied, there could be no distribution because there were no "net profits," for Appellee had operated at a loss upon the whole of the company's business from its organization.

II.

LAWS OF THE STATE OF WASHINGTON PROHIBITING THE DISTRIBUTION OF A DIVIDEND ARE A PART OF THE CHARTER.

A. *Express Reference.*

The Articles of Incorporation expressly refer to the incorporation laws.

> "Article II. That the purposes and objects for which this corporation is formed are * * *
>
> "Nineteenth: To exercise such powers as are or may be granted or conferred by the general incorporation laws of the State of Washington. * * * " (R. 58, 63; Exh. 3).

By this reference the laws become a part of the Charter *as much as if written therein. Interstate Consol. St. R. Co. v. Massachusetts,* 207 U. S. 79, 84, 85; 52 Law Ed. 111, 114.

B. *Part of Charter by Operation of Law.*

The Charter embraces the Articles of Incorporation, the statutes and general incorporation laws of the state of incorporation.

"Thus, while strictly speaking there is no

charter where a corporation is created under a general law, the incorporation papers, whether called articles of incorporation, application for incorporation, certificate of incorporation, or any other term, together with the signature, seal or decree of approval, are often referred to as the charter, although, as a matter of law, the so-called charter consists of such papers and the statutes under which the corporation is created. *In other words, the provisions of the statute or general incorporation laws enter into and form a part of the charter.* This is the meaning applied in construing the corporate charter, in doing which the corporation papers and statute are to be construed together, *the latter controlling in case of a conflict,* and in this respect a charter under general law is the equivalent of one by special act.

"It is not necessary that the *general law* should be copied in the charter, *but it forms an essential part of it,* and all parties are bound by its terms, whether copied in the charter or found only on the statute books. Moreover, constitutional provisions automatically become a part of the charter." *Fletcher, Cyclopedia Corporations,* Perm. ed. Vol. 1, Sec. 164, pp 541, 542. (Italics Supplied.)

The charter and by-laws of a corporation constitute a contract between the company and its stockholders *into which the statutes of the state of its incorporation enter and are controlling.*

Ainsworth v. Southwest Drug Corp. (C.C.A. 5,) 95 Fed. (2d) 172. 173.

"The relationship existing between a corporation and its stockholders is one of contract. (*Shattuck & Desmond Warehouse Co. v. Gillelen* 154 Cal. 778, 99 P. 348), in which the charter and by-laws of the corporation *and pertinent statutes of the state are embodied.* (*Jones v. Northwest Edison Electric Co.* (C.C.A.), 144 Fed.765, 770.)"

Schroeter v. Bartlett Syndicate Bldg. Corporation, (Cal.) 55 Pac. (2d) 1221.

"Where corporations are organized under the general law, * * * * the *charter* of a private corporation *consists not only of the articles of incorporation, but includes all general statutes applicable to that class of corporation,* and *all persons, whether stockholders or creditors, who have dealings with the corporation are conclusively presumed to do so with knowledge of its charter and of its* charter rights * * * * "

Loveland & Co. v. Doernbecher Mfg. Co. (Ore.) 39 Pac. (2d) 668, 673. (Italics supplied.)

"Where possible, we must endeavor to give effect to all *provisions* of the *statute* and *certificates* which are sufficiently clear and definite as to be reasonably understood and expressive of the agreement between the incorporator and between the corporation and its stockholders. *Such provisions are a constitutent part of the contract entered into."*

Yoakam v. *Providence Biltmore Hotel Co., et al.,* (D. C. R. I.) 34 Fed. (2d) 533, 541. (Italics supplied.)

> "It is the rule that, in construing a corporate charter, the incorporation papers and statutes of the state of incorporation are to be construed together. *The statutes need not be copied into the charter, but they form an essential part of it,* and all parties are bound thereby, whether contained in the charter or only in the statutes. Statutory or constitutional provisions *automatically* become a part of the charter. Fletcher on Corporations, Vol. 1., Sec. 164."
>
> *Ontjes v. Bagley,* 217 Iowa 1200, 250 N. W. 17, 19. (Italics ours.)

Appellant does not take issue with the well settled principle that incorporation laws of the state are a part of the Charter. Appellant could hardly take issue with that fact in this case because those laws are expressly referred to in the Articles of Incorporation. Secondly, Appellant does not take issue with the legal principle that a charter is a contract. Appellant's argument may be fairly summarized from the following quotations from his brief:

> "Certainly in normal parlance, those words ('a provision of a written contract executed by the corporation') neither connote nor comprehend the provisions of a state regulatory statute."
>
> "A corporate charter is not a contract 'executed' by the corporation."

The first statement will be answered here, the second under the head *infra* "Executed."

The issue is one of Congressional intent. The test to apply to words for determining that intent is set

forth in the cases cited by Appellant of *Lynch v. Allworth-Stephens Co.*, 267 U. S. 364, 370; *Old Colony R. Co. v. Commr.*, 284 U. S. 552, 560; and *Levy's, Lessee, v. McCartee*, 6 Pet. 102, 110. We quote from these cases.

> "The Legislature must be presumed to use words in their known and ordinary signification unless that sense be repelled by the context." *Levy's, Lessee, v. McCartee, supra.*
>
> And the plain, obvious and rational meaning of a statute is always to be preferred to any curious, narrow, hidden sense that nothing but the exigency of a hard case and the ingenuity and study of an acute and powerful intellect would discover." *Lynch v. Allsworth-Stephens Co., supra.*

In the latter case, provision was made for deduction from gross income to include a reasonable allowance for the "exhaustion * * * of property." This Court stated:

> "There is nothing to suggest that the word 'property' is used in any restricted sense."

It was held that the word was not to be given a restricted meaning.

In *Old Colony R. Co. v. Commr., supra,* it is stated:

> " 'The popular or received import of words furnishes the general rule for the interpretation of public laws. * * * " (p. 560)
>
> "We can not believe that Congress used the word (interest) having in mind any concept other than the usual, ordinary and every day meaning of the term, or that it was acquainted

with the accountant's phrase 'effective rate' of interest and intended that as the measure of the permitted deduction. * * * " (p. 561.)

"If there were doubt as to the connotation of the term, and another meaning might be adopted, the fact of its use in a tax statute would incline the scale to the construction most favorable to the tax payer." (Citing cases) (p. 490.)

Appellant tries to distinguish between contract and statute. The fallacy in this argument is that the statute is both expressly and by operation of law a *part of the contract.* It is not something unrelated to the contract. It *is* the contract and if there is conflict between the *words* in the articles and the laws made a part of the articles, the laws prevail. *Oregon R. R. & Navigation Co. v. Oregonian Ry. Co.,* 130 U. S. 1, 21, 24, 25; *Ex parte Norfolk Ry. & Light Co.,* 142 Va. 323, 128 S. E. 602, 603, 604. Corporations have a very different status in some respects than individuals and the status of a corporation with the state and with its stockholders requires the embodiment of statutory provisions in the corporation's very charter because of that unusual relation.

Appellant's argument attempts to distinguish between a voluntary obligation and a statutory restraint. Again, the distinction is inaccurate. The incorporation laws become a part of the contract and their terms are *voluntarily* accepted by the corporation and acted upon.

Thus the Circuit Court opinion is correct in drawing the conclusion that the incorporation laws are

a part of the contract and "Aside from that, the taxpayer's Articles of Incorporation 'expressly' refer to the general incorporation laws of the State of Washington. * * * " (R. 80.)

Appellant contends that the provision must be *expressly* written in the contract. The statute does not so state. The words are:

> "Provision of a written contract * * * which provision *expressly deals* with the payment of dividends."

The provision may be either written in or incorporated by reference or made a part of the contract by operation of law. In either case the provision is a part of the contract.

III.

CHARTER OF APPELLEE IS A "WRITTEN CONTRACT."

A. *"Written."*

The Articles of Incorporation are in writing. Likewise the laws of the state are written.

B. *"Contract."*

That the charter of a corporation is a *contract* has been so long established that it seems superfluous to argue the matter. *Trustees of Dartmouth College v. Woodward,* 4 Wheat. (U.S.) 518, 627, 4 Law Ed. 629.

> "The charter of a private corporation constitutes a contract, not only between the state and the corporation, the shareholders and the corporation but also between the state and the shareholders. This is settled law. *Wilmington RR. v. Reid,* 13 Wall 264, 20 Law Ed. 568; *Larabee v. Dolley* (D.C.) 175 Fed. 365, 390; *Garey v. Mining Co.,* 32 Utah 497, 91 Pac. 369,

12 L.R.A. (n. s.) 554; *Cook* on *Corporations* (3rd ed.) 492 to 496, incl. The transaction necessarily involves the assent of the shareholders." *Tyler v. Dane County* (D.C.- Wis.) 289 Fed. 843, 855, 856.

To the same effect: *Home Bldg. & Loan Assoc. v. Blaisdell,* 290 U. S. 398, 429, 430; *Gorman v. A. B. Leach & Co., Inc.,* (C.C.-N.Y.) 11 Fed. (2d) 454, 456; *Sanderson v. Salmon River Canal Co.,* 45 Idaho 234, 263 Pac. 32. *Personal Industrial Bank v. Citizens Budget Co.,* 80 Fed. (2d) 327, 328 (CCA-6); Cert. den. 298 U. S. 674.

As this Court stated in *Chango Bridge Co. v. Binghampton Bridge Co.,* 70 U. S. 51, at 73, the principle that an act of incorporation is a contract is so well settled that the Courts are:

> "Estopped from questioning the doctrine," and:
>
> "The security of property rests upon it, and every successful enterprise is undertaken, in the unshaken belief that it will never be forsaken. * * * An attempt even to reaffirm it, could only tend to lessen its force and obligation."

IV.

"Executed by the Corporation Prior to May 1, 1936."

Black's "Law Dictionary" (3d ed.), p. 716 defines "executed" as follows:

> "Completed; carried into full effect; already done or performed; taking effect immediately; now in existence or in possession; conveying an immediate right or possession. The opposite of executory."

Bouvier's "Law Dictionary," Vol. I, p. 1111, (Rawle's Revision) defines the word "executed" as follows:

> "Done; completed; effectuated; performed; fully disclosed; vested; giving perfect right of employment."

In Washington Finance Corp. v. Glass, 74 Wash. 653, 661, 134 Pac. 480, 483, the Court stated:

> "A note is executed when it is complete in its parts and *launched on the current of trade.* The note sued on, although signed by certain parties and in this sense executed by them was not an executed instrument within the meaning of the law. It was not ready for delivery nor was it delivered until the name of the payee was inserted and the endorsement made.
>
> " 'Execution of a note requires both a signature and delivery. In a legal sense the word 'execute' includes delivery and *implies a complete contract.' Words and Phrases,* Title 'Execute.'" (Italics supplied.)

Thus if delivery is essential and if the word "execute" implies a completed contract, there must be a contract *in being* before the "execution" can be said to have taken place. When the contract of incorporation comes into being, however, it comes into being because of the state *and* the *corporation.*

In *Gerlach, et al v. Spokane,* 68 Wash. 589, 591, 592, 124 Pac. 121, 122, the Court held that the word "execute" had a broader meaning than "to sign."

In *Fenby v. Hunt,* 53 Wash. 127, 101 Pac. 492, 493, 494, the question arose whether a chattel mortgage had been filed within time, the statute re-

quiring that in order for the mortgage to be valid as to third persons it must be filed within ten days from "date of execution." The Court held that execution requires acts necessary

> "To give the instrument validity *as between the parties.*"

and that there must be delivery and acceptance and a *meeting of the minds.*

The Senate Finance Committee, in referring to this statute, referred to contracts:

> "*Entered into* prior to March 3, 1936."

(Finance Committee Report No. 2156, 74th Congress, 2d Session, p. 12.)

The Ways and Means Committee of the House referred to

> "Written contract *in existence* prior to March 3, 1946,"

(Ways and Means Committee Report 2475, 74th Congress, 2d Session, p. 8). This, we submit, was the real meaning which Congress had in mind. The purpose of fixing a date was obviously to prevent corporations from entering into contracts to evade the law. Any contract "entered into" or "in existence" prior to that fixed time, so long as it conformed to the other requirements, was obviously intended to be within the scope of the Act. It is significant that the word "executed" is nowhere referred to in Congressional discussions as having a technical meaning. It is further significant that neither in the Board of Tax Appeals nor before the Ninth Circuit Court did the Commissioner argue that the word "executed" must be confined to a strictly technical, narrow and restricted meaning.

> "Are charters contracts 'executed by' the corporation? Congress seems to have given little special thought to its use of the word 'executed.' The Ways and Means Committees refers to a 'written contract' in existence prior to March 3, 1936 (this date being extended to May 1, 1936.) Later the Senate Finance Committee refers to contract 'entered into prior to March 3, 1936 (date extended as above stated). If the word 'executed' is to be given the meaning attributed to that word by previous decisions of the Court, it should probably be held to require only such acts as are necessary to bind the corporation by the written contract in question. Precise formality should be unimportant if there is a binding obligation. A broad meaning should be given to the word 'execute' which properly ignores technicalities." *Paul & Mertens, "Law of Federal Taxation,"* 1939 Cum. Supp., 32 A. 43 at p. 1458.

Employing the synonyms for the word "executed" in accordance with the above definitions and Court decisions, the *quaere* is whether the Charter of Northwest Steel Rolling Mills, Inc. was:

> "Entered into, in existence, completed, effectuated, performed, vested, carried into full effect, launched on the current of trade as a complete contract."

prior to May 1, 1936. The Charter was not unilateral. The offer was extended by the state permitting incorporation under certain conditions. That offer required an acceptance. That acceptance required an acceptor. The acceptor could be none other than

the corporation itself. The very act of incorporation imports a binding obligation and that binding obligation is one assumed by the corporation directly and positively, imposing upon the *corporation* duties to the state, to the stockholders and to creditors.

Appellant argues that the word "executed," "when used with reference to a written *instrument,*" means "signed, sealed and delivered." It will be observed however that the statute does not use the word "instrument." It states "written *contract.*" The common and ordinary meaning which was intended by Congress in the use of the word "executed" was that meaning which the Ways and Means Committee of the House and the Senate Finance Committee used in connection with the word and which the Treasury Department itself applied to the word namely, "entered into" or "in existence," prior to a certain date. Was there a binding obligation in writing prior to May 1, 1936, is the real question. The stress was not intended to be upon the act of making the contract. The stress was laid upon the time when the contract went into effect.

Appellant lays stress upon signing, but 'executed' is a much broader term than 'signing,' as the definitions above quoted indicate. In short, Appellant attempts to apply a restricted and technical meaning to the word, although stating as a premise of the construction that the popular and ordinary meaning should be accepted.

Appellant cites *Bouvier's "Law Dictionary,"* (Rawle's 3rd Rev.), Vol. I, p. 1111, to sustain the contention that "executed" means "signed," or "signed, sealed and delivered." Bouvier states:

> "To execute a deed, which means to make a deed, including especially signing, sealing and delivery."

It will be seen that this refers to a written *instrument* and that "execute" or "make," even as to a written instrument is a broader term than "signing, sealing and delivery." The broader meaning of "completing" etc. quoted *supra* is imported by the word "make." A deed may be signed and delivered by an agent having power of attorney. That does not prevent the deed from being "made" although the grantor does not himself sign or deliver the deed. Here, the incorporators were agents of the company, if ratification is accepted as the correct principle.

A corporation is bound by preorganization contracts of its incorporators, if these contracts are approved subsequent to incorporation, and this binding effect results from ratification. *Walnut, Park Lumber & Coal v. Roane, et al,* 17 Pac. (2d) 896, 898, 171 Wash. 362, 368 (1933). Certainly, the Charter has been approved and acted on.

> "The acceptance of a charter by the corporation arises from merely acting under it." *Ashby v. Standard Pipe & Supply Co.* (Tex. Civ. App.) 56 S. W. (2d) 218, 222.
>
> "A certificate of incorporation evidences a contract between the state *and the corporate entity created thereby." State ex rel. Sutherland v. U .S. Realty Imp. Co.,* 15 Del. C. H. 108, 132 Atl. 138.

The acceptance of a charter binds the corporation to performance of all conditions upon which it is

granted. *Ashley v. Ryan,* 153 U. S. 436, 441, 443, 38 Law Ed. 773, 776, 777. *Fed. Crude Oil Co. v. Yount-Lee Oil Co.,* 122 Texas 21, 52 S.W. (2d) 56, 60; *Badger Dome Oil Co. v. Hallam,* 99 Fed. (2d) 293, 297.

The opinion of Story, J., in *Trustees of Dartmouth College v. Woodward,* 4 Wheat. 518 at 691, 692, 693 is a clear exposition of the execution of a charter.

> "I am unable to distinguish between the case of a grant of land or of franchises to an existing corporation, and a like grant to a corporation brought into life for the very purpose of receiving the grant. As soon as it is in esse, and the franchises and property become vested and executed in it, the grant is just as much an *executed contract* as if its prior existence had been established for a century." (Italics supplied).

This is particularly true in the State of Washington where there is practically identity between incorporators and corporation.

> "When the certificate shall have been filed, the persons who shall have signed and acknowledged the same, and their successors, shall be a body corporate and politic in fact and in name, * * * ." *Rem. Rev. Stat.* 3809; Cd. '81 Sect. 2424; 1 H. C., Sect. 1500.

Appellant argues that "executed" would be superfluous under the construction given by the 9th Circuit. This argument overlooks the fact that "executed" is used, not in relation to *how* the written contract must be made, but rather *when* it must be

made. Had it not been for the fixing of a date beyond which a contract, although binding upon the corporation, would not be within the credit, the pertinent portion of the statute would undoubtedly have read:

> "Provision of a written contract expressly dealing with the payment of dividends."

It would have been unnecessary to have used the word "executed" except for the fact that Congress wished *to fix a limiting date.* The sense in which the phrase "executed by a corporation prior to May 1, 1936," is used, obviously is in relation to time and not in relation to manner. Congress had no concern with whether the contract was made by an agent, typed, printed or written in long hand so long as it was a binding, written contract, and so long as that contract was completed and in force prior to May 1, 1936. If the *manner* of making the contract had been important to Congress, undoubtedly Congress would have made some explicit provision to that effect. The words "executed by a corporation" are no more superfluous therefore than the words "entered into" or "in existence" prior to May 1, 1936, would have been. It would have been inept to say:

> "Provision of a written contract prior to May 1, 1936, which provision * * *."

Appellant confuses an act with a fact—it is the *fact* that a written contract is in being before May 1, 1936, not the *act* by which that contract came into being, to which the words "executed by the corporation prior to May 1, 1936" apply.

V.

Appellee's Charter Expressly Deals With Distribution of Dividends

The articles of incorporation *expressly* recognize that the powers of the corporation are those conferred by law. The law *expressly* restricts the corporation with respect to payment of dividends. The law is a part of the Charter both by express reference in the Articles and by accepted legal principles, *as much as if written in the Articles. Ontjes v. Bagley,* 250 N.W. (Ia.) 17, 19; *Ainsworth v. Southwest Drug Corp.* (C.C.A.-5) 95 Fed. (2d) 172, 173; *Yoakam v. Providence Biltmore Hotel Co., et al* (D.C.-R.I.) 34 Fed. (2d) 533, 541; *Fletcher, "Cyc. Corporations,"* (Perm. Ed.) Vol. I, §164, pp. 541, 542.

As stated in the opinion of the Ninth Circuit in this case,

> "The mere fact that the statute prohibits the payment of dividends during *any* year in which there is a deficit, certainly cannot militate against the idea that the statute 'expressly' deals with the disposition of profits during the year in question. See *G. B. R. Oil Corporation v. Commissioner,* 40 B.T.A. 737." See also *Joel Co. v. Commissioner,* 41 B.T.A. 829.

In *Michigan Silica Company v. Commissioner* decided Mar. 5, 1940, 41 B.T.A. No. 77 a trust indenture required the corporation to pay to a trustee 25c for each ton of sand produced and sold. Dealing with section 26 (C) (2), the Board observed:

> "It is true that this provision of the trust indenture does not 'expressly' use the term 'earnings and profits.' The statute however does

not require that such terms be used in the written contract, but only that the written contract contain a provision which 'expressly deals with the distribution of earnings and profits of the taxable year.' Applying that test, we submit that Article 3 of the trust indenture does expressly deal with the disposition of earnings and profits of the taxable year."

VI.

Interpretation of Section 26 (C) (I) to Allow the Credit Conforms With Rules of Construction.

A. *Any other Construction Would Discriminate Against Deficit Corporations Prohibited by Charter from Distributing Dividends.*

The dividend paid credit, Section 27, Revenue Act of 1936 arises where (a) "Dividends" are paid, or (b) Where part of a distribution in liquidation of the company is properly chargeable to the earnings or profits *accumulated* after February 28, 1913.

The word "dividends" as used in Section 27 is defined in Section 115 as follows:

> "(a) Definition of dividends — The term 'dividends' when used in this title means any distribution made by a corporation to its shareholders, whether in money, or in property, (1) Out of its earnings or profits accumulated after February 28, 1913 or (2) Out of the earnings or profits of the taxable year (computed as of the close of the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made."

Section 115 (a) (2) *supra* was an addition made

in the 1936 Act and constitutes a very substantial extension of the definition of the term "dividends." Under this definition, if earnings or profits were sufficient during the taxable year, a corporation irrespective of its deficit could have a distribution to stockholders considered as a "dividend" within the meaning of this act, and could thereby obtain a dividend paid credit even though in effect such corporation would be distributing capital.

While there is a deficit there can be no "undivided profits." *Willcuts, Collector, v. Milton Dairy Co.*, 275 U. S. 215, 218; 72 L. Ed. 247, 248.

> "The rule is that a corporation does not have earnings or profits available for distribution as dividends until impairments of capital or paid-in surplus resulting from operating losses have been restored." *Roy J. Kinnear v. Commissioner*, 36 BTA 153, 155.

Accordingly, Congress has explicitly extended the meaning of the word "dividend" for the purposes of this act in order to allow deficit corporations the benefit of a dividend paid credit. This demonstrates no purpose on the part of Congress to discriminate against deficit corporations generally but under the Commissioner's interpretation the Congress must have intended to discriminate against deficit corporations which by reason of their Charter could not, while having a deficit distribute dividends. Such intent on the part of Congress should not be implied lightly, especially in view of the extended definition which Congress deliberately gave to the term "dividends" with respect to dividend paid credits. Congress knew and is charged with knowledge that in

thirty-six states such prohibitions existed against deficit corporations.

The absurd result of the Commissioner's interpretation is that Congress must have intended to favor corporations in the twelve states allowing deficit corporations to distribute dividends, and to discriminate against the corporations in thirty-six states which did not allow the distribution.

> "However, to construe statutes so as to avoid results glaringly absurd, has long been a judicial function." *Armstrong Paint & V. Works v. Nu-Enamel Corp.*, 305 U. S. 315, 333.

Appellant argues that the law was intended to act uniformly throughout the states and that some states do not restrict dividend payments by deficit corporations. Inasmuch as most states restrict dividend payments, Appellant's argument seems to work in reverse. Uniformity can only be attained within the wording and *purpose* of the Act by giving the defiicit corporation which can not distribute dividends the credit under 26 (c) (1) because of a contract (the Charter) restricting the payment of dividends. By construing the Act in that manner, the dividend paid credit may be available to the deficit corporation that can distribute and the contract credit will be available to the deficit corporation that can not distribute.

B. *A Construction Is to Be Avoided Which Will Raise Doubt as to Constitutionality of the Act.*

The majority opinion of the Circuit Court indicates doubt of the constitutionality of this act unless construed as permitting the credit, and in other sections of this brief the constitutionality of the act will be attacked.

"A statute must be construed, if fairly possible, so as to avoid not only the conclusion that it is constitutional, *but also grave doubts upon that score,* * * * " *Linder v. U. S.* 268 U. S. 5, 17, 69 Law Ed. 819, 823; *U. S. v. Jim Fuey Moy,* 241 U. S. 394, 401, 60 Law Ed. 1061, 1064.

C. *Doubts Are Resolved in Favor of Taxpayer.*

If doubt exists as to the construction of a taxing statute, the doubt should be resolved in favor of the taxpayer.

Hasett v. Welsh, 303 U. S. 303, 314, 82 Law Ed. 858, 867.

D. *Relief Provisions Are to Be Liberally Construed.*

The Senate Committee on Finance in its report (Sen. Rep. No. 2156, 74th Congress, 2d Session, p. 15) stated:

"Contracts not to pay dividends: This credit is in principle similar to a *relief* provision allowed in the House Bill for the purpose of the undistributed profits tax imposed by that bill."

The House Report No. 2475, 74th Congress, 2d Session, p. 9, stated:

"A corporation however, can not use more than one of the *relief* provisions which is cited but must use the one that will result in the smallest tax."

Relief provisions in tax acts are to be liberally construed to afford the relief intended. *Bonwit Teller & Co. v. U. S.,* 283 U. S. 258, 263, 75 Law Ed. 1018, 1021.

Appellant argues that this credit falls within the rule as to deductions. Such is contrary to the mani-

fest intent of Congress, stated *supra*. Further, this is not a deduction from income, but relief where distribution of income could not be made.

E. *Administrative Construction to the Effect that a Charter Does Not Constitute a Written Contract Has Not Received Congressional Approval By Re-enactment of the Statute.*

Treasury Department Regulations 94, Art. 26-2, placed a construction upon this Act to the effect that a Charter was not a contract within the meaning of the Act. This construction has not received Congressional approval by re-enactment of the statute in the Revenue Act of 1938.

A regulation, in order to be valid, must be reasonable and in harmony with the statute. *Manhattan General Equipment Co. v. Commr.* (1936), 297 U. S. 129, 134; 80 Law Ed. 528, 531.

This construction by the Treasury Department was entirely new and contrary to all judicial precedent. It is argued that great weight should be attached to the departmental regulation. But there has been no long continued use of the regulation. See: *Iselin v. U. S.* (1926), 270 U. S. 245, 251; 70 Law Ed. 566, 570.

The Court is not bound by an administrative construction. *Burnett v. Chicago Portrait Co.,* (1932) 285 U. S. 1, 16-21.

Inasmuch as Congress was aware that "the laws of 36 states prohibit corporations chartered by them from making a dividend distribution if their capital is impaired" (Congressional Record, Vol. 80, Pt. 8, p. 9058), it can hardly be assumed that the lawyers on the conference committee were unaware of the

long and well established legal principle that the charters of these corporations were contracts and in the absence of legislation indicating the contrary, it is submitted that the Treasury regulation *supra* is without foundation.

F. *Administrative Construction in Other Respects Supports Appellee's Position.*

I. T. 3130, C.B. 1937-2 page 107, indicates the administrative interpretation of the word "executed" in this statute. There was an agreement between two principal stockholders and the corporation in which they held stock that no dividends would be declared until certain advances of the two principal stockholders had been repaid by the corporation and the question presented was whether these were contracts within the meaning of the Act here in question. In other words, was this a written contract executed by the corporation? In passing upon this question the following significant language was used, namely, that the contracts were valid contracts "*entered into* in March 1936, that is prior to May 1, 1936." Here the emphasis properly is placed on the time element and the binding obligation, and not upon the *manner* of making the agreement.

VII.

Legislative History.

The legislative history affords only slight help by reason of the fact that the bill in the House and the bill in the Senate were divergent not only in wording but in aim and purpose.

> "The Conference Committee had the difficult task of reconciling in a limited time two diverse bills actuated by divergent views as to the

> proper attitude toward corporate wealth * * * The House and Senate 1936 bills were dissimilar in general aim, theory and in structure. The 1936 Act, as finally enacted, was to a considerable extent written in conference without any new statement of leigslative intent—a fact which contributes in no small measure to the difficulty of interpretation of the Act." *Paul & Mertens, Law of Federal Income Taxation 1939 Supp.*, Sec. 32 A. 05.

The result is a "hodge-podge." Martin, *"Taxation of Undistributed Corporate Profits,"* 35 Mich. Law Review 44, 72 (1936).

Thus, while specific statements of legislative intent are lacking on the bill as finally drafted and while comments made in the House and Senate are of little assistance due to the fact that this bill was a compromise drafted in conference, there is much to be gleaned as to legislative purpose from the background of the undistributed profits tax. The purpose of this surtax, as expressed in the Ways and Means Committee Report of the House, was fundamentally "a desire to stimulate distribution of corporate profits."

Paul & Mertens, *"Law of Federal Income Taxation,"* 1939 Supp. 32 A. .01, p. 1387, citing Ways and Means Committee Report No. 2475, 74th Congress, 2nd session, p. 5; Ways and Means Committee Hearings, p. 561; remarks of Senator Connally, Finance Committee Hearings, p. 203; Stempf "New Factors in Federal Income Taxation," 62 The Journal of Accountants 42, 247 (1936).

In other words, the uppermost thought was to cause surpluses that were *accumulating* to be handed

out to shareholders who would be taxable for the income so received.

The Congress had been advised as follows in the President's message of March 3, 1936:

> "The accumulation of surplus in corporations controlled by taxpayers with large incomes is encouraged by the present freedom of undistributed corporate income from surtax. * * * "

This obviously is aimed at those corporations where *surpluses* have been voluntarily created because stockholders "who can afford to leave earnings undistributed" prefer that the corporation retain the *surplus* (House Report No. 2475, 74th Congress, Second Session). Also see *Sanford v. Commissioner,* 106 F. (2d) 882, 884; *Maryland Land and T. Co. v. Commissioner,* 40 B. T. A. 1066, 1067, and Senate Hearings p. 265 to 268—Examination of witness by Senator Black. The corporation faced with a deficit presented no problem because it could make no distribution of dividend and it is submitted that the Congress never intended to carry the idea of forced distribution to the point where a deficit corporation and its directors must commit an illegal act to make the distribution.

Not only must the Commissioner assert that the Congress intended to compel such illegal distribution by deficit corporations but he also must contend that the Congress actually intended to discriminate *against* such deficit corporations restrained by law from making dividends, by cutting off their access to the dividend paid credit. The result is harsh and the reasoning by which the result is obtained is technical and unsound.

Appellant devotes much space to legislative his-

tory. But summarized, the argument on this score is that Congress in 1936 intended to tax deficit corporations who could *not* distribute dividends and to exempt those who could and did distribute dividends, and that, in 1938, Congress realized the injustice of the measure and

> "For this reason, among others, substantially modified"

the Act. Appellant's argument requires that an injustice, recognized as such, be corrected by legislation. Appellee's argument follows that construction of the Act consistent with its purpose and wording which defeats the injustice at its source. Appellant's argument assumes that the lawyers on the committee were unaware of the time honored principle that a corporate charter is a contract. Appellant's argument further assumes that the elimination of a provision in a totally different bill, which provision taxed earnings 22 per cent if above the deficit, imports an intent in the Senate bill to tax irrespective of a deficit. Appellant confuses the beliefs of the majority and the minority of the committee. The *minority* report (80 Cong. Rec., Pt. X. p. 10164) points out that the *majority* ("the defenders of the bill") contend that by exemptions and modifications the smallest corporations are assisted. This is hardly consistent with an intent to tax deficit corporatons.

We take sharp issue with that portion of Appellant's brief which argues that the "Failure of Congress to provide specifically for the relief of deficit corporations was deliberate."

We submit that the remedy afforded in 1938 of a situation brought about by an unwarranted ad-

ministrative interpretation evidences an intent by Congress to give relief to deficit corporations.

VIII.

Stock Certificate.

The argument advanced in the Crane-Johnson brief on behalf of the taxpayer that the stock certificate is a contract within 26 (c) (1) is adopted by Appellee herein. A brief statement of the argument will suffice in view of such reference to the Crane-Johnson brief. Appellant does not question the premises that the stock certificate is a contract (*Clearwater v. Meredith*, 1 Wall. 25, 40) and that the state corporation law is a part of that contract (*Home Bldg. & Loan Assn. v. Blaisdell*, 290 U. S. 398, 429, 430). Appellant argues that the corporation laws are not "expressly written' in the stock certificate and are therefore a part of the certificate by implication only. The statute, however, refers to a provision expressly dealing with dividend payments rather than a provision expressly written in the contract.

It is a matter of common knowledge that corporations issue stock certificates. At the time of the conversations with the bank, the question of whether stockholders should receive dividends was broached. Obviously these stockholders held stock certificates.

Appellee urges, however, that the *manner* of execution is unimportant. The time when the contract came into effect is important. In that light, whether we refer to a stock certificate or to a charter, a contract had been entered into and was binding upon the corporation.

IF CONSTRUED TO DISALLOW THE CREDIT THE ACT IS UNCONSTITUTIONAL.

I.

The Act Is Arbitrary and Discriminatory in Violation of the Fifth Amendment to the Federal Constitution.

If the construction contended for by the Commissioner is adopted, then corporations who reduced to writing contracts entered into by them would receive a credit, whereas those making verbal agreements, as was the case with Northwest Steel in its agreement with the bank (R. 41, 47, 50) would receive no credit. Further, corporations which make contracts with individuals receive the credit, but because the corporation has made its contract with the state (a contract of the highest order) then under the Treasury's construction the corporation is prevented from obtaining the credit. If such construction is adopted of the statute, then the statute is arbitrary and discriminatory, for there is no reason to make one rule with respect to a private contract and another rule with respect to a contract between the corporation and the State, both contracts being in writing.

As between an oral and a written contract, it will be argued that there is reasonableness in drawing a distinction because of the difference in proof, but this contention is of no avail with respect to a corporate charter. No reasonable distinction can be drawn between a charter and any other type of written contract.

A Federal statute passed under the taxing power may be so arbitrary and capricious as to cause it

to fall before the due process of law clause of the Fifth Amendment. *Heiner v. Donnan,* 285 U. S. 312, 330-332; 76 L. Ed. 772, 781, 782. *Tyler v. U. S.* 281 U. S. 497, 504; 74 L. Ed. 991, 999.

The language in *Nichols v. Coolidge,* 274 U. S. 531, 542, 71 L. Ed. 1184, 1192, is by analogy pertinent to this situation.

> "The statute requires the executors to pay an excise ostensibly laid upon transfer of property by death from Mrs. Coolidge to them but reckoned upon its value plus the value of other property conveyed before the enactment in entire good faith and without contemplation of death. Is the statute thus construed within the power of Congress?
>
> "Undoubtedly, Congress may require that property subsequently transferred in contemplation of death be treated as part of the estate for purposes of taxation. This is necessary to prevent evasion and give practical effect to the exercise of admitted power *but the right is limited by the necessity.*"
>
> "Under the theory advanced for the United States the arbitrary, whimsical and burdensome character of the challenged tax is plain enough. An excise is prescribed but the amount of it is made to depend upon *past lawful transactions,* not testamentary in character and beyond recall. * * * *Different estates must bear disproportionate burdens determined by what the deceased did one or twenty years before he died.* See *Frew v. Bowers* (CCA 2d), 12 Fed. 2d 625.
>
> "This Court has recognized that a staute

purporting to tax may be so arbitrary and capricious as to amount to confiscation and offend the 5th Amendment. *Brushaber v. Union Pacific R. Co.*, 240 U. S. 1, 24; 60 L. Ed. 493, * * *

"And we must conclude that Section 402 (c) of the statute here under consideration, insofar as it requires that there shall be included in the gross estate the value of property transferred by a decedent *prior to its passage* merely because the conveyance was intended to take effect in possession or enjoyment at or after his death, is arbitrary, capricious and amounts to confiscation." (Italics supplied.)

So, here, the tax and the credit are based upon some act done in the past. There must be some reasonable ground for distinguishing between such acts. There is no *necessity* to impose the tax on deficit corporations to prevent evasion. There is no *necessity* to discriminate between a written contract and a charter. Such distinction would be purely arbitrary and capricious.

In addition to such arbitrary and unwarranted discrimination the tax as imposed upon deficit corporations prohibited by law from distributing a dividend amounts to confiscation of the property of the corporation without due process because the tax is imposed, not on income, but on undistributed income and there is no undistributed income so long as there is a deficit. *Willcuts, Collector v. Milton Dairy Co.*, 275 U. S. 215, 218; *Roy J. Kinnear v. Commissioner*, 36 BTA 153, 155; *Foley Securities Corp. v. Comm'r.*, 106 F. (2d) 731. Thus, in reality, the tax is on capital, not income. Likewise, the distribution to the stockholder would be capital and

not income. *Eisner v. Macomber,* 252 U. S. 189.

Appellee could not receive a credit for a dividend paid upon making such a "distribution." Under the Act, undistributed net income is adjusted net less the sum of the *dividends paid* credit. Section 27 (h) provides that if any part of a distribution is "not a taxable dividend" in the hands of the shareholders, no dividends paid credit shall be allowed with respect to such part. Congress cannot make that a dividend which is distribution of capital. If it could, the distribution would not have availed Appellee because Appellee, "as of the close of the taxable year" had no "earnings or profits" within the meaning of Sec. 115 (a) (2). *Roy J. Kinnear v. Comm'r.,* 36 BTA 153, 155, 156. Change in the statute there construed does not alter the principle there applied. Also see *Foley Securities Corp. v. Comm'r.,* 106 F. (2d) 731.

If the Act is construed as allowing a dividend paid credit to a deficit corporation, then it discriminates between deficit corporations. The corporation whose contract with the State prevents a distribution is denied the credit; the corporation whose contract with the State does not prohibit distribution of its assets even though a deficit exists can obtain the credit by a "dividend paid credit." All of these distinctions rest upon some act done prior to the enactment of this law and not in contemplation of the law No claim can be made that the act of entering into a charter is an illegitimate act or an act possessing any intent on the part of a corporation to avoid any tax or other exaction. If it be said that Congress may in its discretion allow or disallow credits, then our answer is that Con-

gress may not, under the pretext of taxing income, tax capital disproportionately. If it be said that Congress may discriminate reasonably, then our answer is that a discrimination between a written contract and a charter is unreasonable, arbitrary and in disregard of all legal principles. We submit that Congress had no such intention to discriminate and that the discrimination has arisen solely as the result of the Treasury's unwarranted regulations. But if the statute must be read to invoke such discrimination, then we respectfully urge that the Act should be stricken down as applied to Appellee as arbitrary, capricious, unreasonable and therefore unconstitutional. In addition, if there are doubts as to the constitutionality, then the statute should be so construed as to avoid such doubts. We submit that the following statement from the majority opinion of the Circuit Court is correct:

> "This impels the conclusion that the Act in question should be construed so as to include the taxpayer's corporate charter within the term 'written contract executed by the corporation,'."
>
> 'There seems to be grave doubt as to whether there is a reasonable basis for discrimination between a written contract actually 'signed' by a corporation prohibiting the payment of dividends, and the contract of the charter to which the corporation is as fully bound, likewise prohibiting the distribution of profits. The 'administrative convenience,' which we have above held lends a basis for the distinction between oral and written contracts, would not seem to

apply with equal force to this situation." (R. 81, 82.)

Appellant argues that classification of income as distributed or undistributed is proper, citing *Helvering v. National Grocery Co.*, 304 U. S. 282. The Act construed in that case pertained to corporations which were *formed or availed of* for the purpose of accumulating income and thereby preventing the imposition of surtaxes on their stockholders. The gist of the tax there was not alone the failure to distribute dividends but the deliberate use of the corporation for the purpose of avoiding tax on the individual stockholder. Kohl was the sole owner of the business. The question was whether a corporation "availed of" by him for the purpose of avoiding surtax upon his individual income could be taxed 50 per cent of its net income in addition to normal tax. A condition precedent to the additional tax on net income was the "existence of a defined purpose" "of preventing the imposition of the surtax" upon Kohl. The act was in effect designed to prevent fraud as is shown by the citation of *Helvering v. Mitchell*, 303 U. S. 391, in support of the opinion.

There is a substantial difference between the imposition of a tax based upon non-distribution plus a purpose to avoid surtax and a tax on undistributed net income where not only the purpose to avoid tax is lacking, but the distribution can not legally be made.

Appellant states that Congress may make any classification reasonably designed "to afford an equitable distribution of the tax burden." How the instant measure as applied to Appellee can be jus-

tified as an *equitable* distribution of the tax burden under Appellant's construction is beyond understanding.

Almours Securities v. Commr., 91 Fed. (2d) 427 (CCA-5), is cited. The holding there was that taxpayer had accumulated profits beyond reasonable needs of its business and the corporation was "availed of" for the *purpose* of preventing imposition of surtaxes upon its shareholders. The decision recognizes that the means employed to carry out a legitimate taxing purpose must be "plainly adapted to that end" (p. 429). Is the means "adapted to that end" when a corporation is taxed because of accumulated, undistributed profits when in fact there are no accumulated profits and no distribution could be made legally?

In *United Business Corporation v. Commr.*, 62 Fed. (2d) 754, the *intent* of taxpayer is stressed.

> " * * * The test remains the state of mind itself." (p. 755.)
>
> "While the forbidden purpose is of those who use the company, that purpose may be imputed to the company itself, since they can not use it unless they are in control, and it can have no other than an imputed purpose anyway." (p. 756.)

Intent to use a corporation to evade personal tax may give rise to regulation as an incidence to tax. That is a far cry, however, from regulation designed to tax a corporation to force it to do that which it can not legally do because of its contract with the state and stockholders.

In any event, the tax is not upon corporate profits as such, but the tax is intended to require distribu-

tion of those corporate profits to individuals. The distinction between distribution and non-distribution is not because one corporation is paying a lighter tax than another. In effect the law is a tax upon a corporation engaged in entirely legitimate pursuits to require the corporation to hand over funds to stockholders so that the stockholders can be taxed in a greater amount.

Appellant argues that this tax is valid because credits are matters of legislative grace. That is no answer to the objection that as to deficit corporations, the tax is upon capital and not on income.

Further, an act which is arbitrary and discriminatory is not made less so because Congress could have granted a credit which would have operated to prevent discrimination in a particular case.

Appellant urges that an "intolerable burden" would be imposed in administering the law. The Bureau is "conclusively presumed" in its dealings with the corporation to have "knowledge of its charter." *Loveland & Co. v. Doernbecher Mfg. Co.* (Ore.) 39 Pac. (2d) 668, 673. Would it be "intolerable" if a written contract between X corporation and a creditor provided that so long as X corporation was insolvent it must not declare dividends? If not, then the problem of administration is no greater with respect to charters. In the one case there must be a determination of fact as to insolvency, and in the other a determination of fact as to a deficit. Internal Revenue officials must often consider state laws. See *Lang v. Commr.*, 304 U. S. 264; *Blair v. Commr.*, 300 U. S. 5; *Crooks v. Harrelson*, 282 U. S. 55.

And so long as "practical considerations" are being discussed, we submit the administrative problem is comparatively simple to the problem presented to the taxpayer who must violate the state law to obtain the Federal tax credit, under the Bureau's interpretation.

> "However, to construe statutes so as to avoid results glaringly absurd, has long been a judicial function." *Armstrong Paint & V. Works v. Nu-Enamel Corp.*, 305 U. S. 315, 333.

This statute presents a situation where the above quote is unusually apt. It is "glaringly absurd" for the Federal Government to require payment of a tax because the State Government makes unlawful the distribution of a dividend.

In connection with the argument of intolerable burden, it is well to bear in mind that for purposes of annual depreciation deduction, corporate assets of all corporations have been valued. Furthermore, the Bureau considers valuation for purposes of capital stock tax and of estate tax valuations. There are annual income tax returns. The Agents have access to the books of the corporation. Each year, the corporation is under scrutiny. If any sale of physical assets is made, that sale is subject to study by reason of possible gain or loss. The ascertainment of such facts has never been considered insuperable. Having such facts, the ascertainment of a *surplus* or deficit should not be intolerable.

II.

The Act Constitutes an Invasion by the Federal Government of the Powers Delelgated to the States to Regulate Corporations and Violates the Tenth Amendment.

"Powers not yet delegated to the United States by the Constitution, nor prohibited by it to the State, are reserved to the States respectively, or to the people." Amendment X, *Federal Constitution.*

States have the inherent power to prescribe the powers of corporations and the conditions under which those powers may be exercised. 14 *C. J.*, "Corporations," §56, p. 94:

" * * * While the States are not sovereign in the true sense of that term, but only quasi sovereign, yet in respect of all powers reserved to them they are supreme—'as independent of the Federal Government as that Government within its sphere is independent of the State.' * * * It is no longer open to question that the general government, unlike the State * * * possesses no inherent power in respect of the internal affairs of the State; and emphatically not with regard to legislation." *Carter v. Carter Coal Co.,* 298 U. S. 238, 294, 295; 80 Law Ed. 1160, 1180.

To the same effect:

Thurlow v. Mass., 5 How. 504, 588, 12 Law Ed. 256, 294.

"A state, through its Legislature, may regulate all corporations, without regard to their nature, just the same as they may regulate an individual, except insofar as the power to regulate is precluded by constitutional provisions or by provisions in the charter or franchise."

Fletcher Cyc. Corporations (Perm Ed.) Vol. 14, Chap. 59, Sec. 6684, page 39.

"The power of taxation, which is expressly granted, may, of course, be adopted as a means to carry into operation another power also expressly granted. But resort to the taxing power to effectuate an end which is not legitimate, not within the scope of the constitution, is obviously inadmissible.

" 'Congress is not empowered to tax for those purposes which are within the exclusive province of the states.' Gibbons v. Ogden, 9 Wheat. 1, 199, 6 L. Ed. 23, 70."

" 'There are, indeed, certain virtual limitations, arising from the principle of the Constitution itself. It would undoubtedly be an abuse of the (taxing) power if so exercised as to impair the separate existence and independent self government of the states, or if exercised for ends inconsistent with the limited grants of power in the Constiution.' *Veazie Bank v. Fenno,* 8 Wall. 533, 541, 19 Law Ed. 482, 485." *U. S. v. Butler,* 297 U. S. 1, 69, 80 Law Ed. 477, 490, 102 A.L.R. 914, 927.

In the Butler case, the Government argued that the plan was voluntary and therefore avoided constitutional objections, but this Court's opinion stated:

"The farmer, of course, may refuse to comply but the price of such refusal is the loss of benefits. The amount offered is intended to be sufficient to exert pressure on him to agree to the proposed regulation." (pp. 70, 71 (U.S.); 491 (Law Ed.))

So here, the taxpayer may obey the State law and make no distribution of dividend and pay the tax. But the Federal tax is:

> "Intended to be sufficient to exert pressure on him."

to make the distribution. This is evident from the statements of purpose behind the law.

> " 'A statute must be construed, if fairly possible, so as to avoid not only the conclusion that it is unconstitutional, but also grave doubts upon that score.' * * *
>
> "Obviously, direct control of medical practice in the state is beyond the power of the Federal Government. Incidental regulation of such practice by Congress through a taxing act can not extend to matters plainly inappropriate and unnecessary to reasonable enforcement of a revenue measure. * * *" *Linder v. U. S.*, 268 U.S. 5, 17, 18, 22, 69 Law Ed. 819, 823, 825.

It is not necessary for the reasonable enforcement of this revenue measure that a corporation should be compelled or by pressure of taxation, induced to make a distribution contrary to the laws of the State and possibly to the jeopardy of creditors of the corporation. If it was the intent of Congress that, irrespective of State regulations to the contrary, the tax would compel or induce the corporation to make the distribution or else pay an onerous penalty to the Federal Government for the failure to make that distribution (one expressed purpose of this undistributed profits tax was to accelerate the distribution of money held by corporations), then we submit that the Act was beyond the power of Congress and results in a direct interference with the control by the State of corporations.

III.

Tax Is Not On Income Within Sixteenth Amendment But Is On Capital and Is Invalid Because Not Apportioned.

It is not net income of the corporation which is taxed, but rather *undistributed* net income. *Undistributed* net income is arrived at after determining an *adjusted* net income, but with deficit corporations there can be no such thing as *undistributed net income* because all earnings must automatically help replace the deficit. Since Appellee had no undistributed surplus, this tax, if imposed, would be directly upon the capital of the company and must be apportioned.

In *Willcuts v. Milton Dairy Co.*, 275 U.S. 215, 218, 72 Law Ed. 247, 248, it is stated:

> "Hence, where the capital is impaired, *profits, though earned and remaining in the business, if insufficient to offset this impairment do not constitute 'undivided profits.'* * * * We do not think Congress intended that a corporation whose capital was impaired should be entitled to treat profits that, though earned, were insufficient to make good the impairment and create a surplus, as 'undivided profits.' This would not only give the term 'undivided profits' a meaning entirely at variance with ordinary usage,—making it merely equivalent to any earned profits remaining in the business,—but would grant the privilege of twice disregarding the impairment of capital, that is, once in computing the paid-in capital, which under the express terms of the act was to be taken at the full cash or

money value at the time of payment, and again in computing the 'undivided profits.' This term is entirely inept to express such a purpose." (Italics supplied.)

So here there could be no *undistributed* income so long as the income made during the tax year was needed to relieve an impairment of capital. Any tax imposed on so-called undistributed income was therefore no more than a tax upon capital. As such it is not an income tax within the 16th Amendment and must be apportioned. *Eisner v. Macomber,* 252 U.S. 189, 64 Law Ed. 521. In that case this Court stated:

"That Congress has power to tax shareholders upon their property interest in the stock of corporations is beyond question; and that such interest might be valued in view of the condition of the company, including its accumulated and undivided profits, is equally clear. But that this would be taxation of property, because of ownership, and hence would require apportionment under the provisions of the Constitution, is settled beyond peradventure by previous decisions of this Court." (p. 217.)

"Thus from every point of view we are brought irresistibly to the conclusion that neither under the 16th Amendment nor otherwise has Congress power to tax without apportionment a true stock dividend made lawfully and in good faith, *or the accumulated profits behind it,* as income of the stockholder. The Revenue Act of 1916, insofar as it imposes a tax upon the stockholder because of such dividend, contravenes the provisions of Article

I, Section 2, Clause 3, and Article I, Section 9, Clause 4 of the Constitution, and to this extent is invalid notwithstanding the 16th Amendment." (Italics supplied) (p. 219.)

The reasoning in the *Eisner v. Macomber* case is simply that a stock dividend represents no division of income derived from capital but merely represents a division of capital. Similarly if Appellee had made a division of its undistributed income, it would not have been dividing something which accrued from capital or was derived from capital, but it would have been dividing the very capital itself.

We are not dealing with a corporation formed for the purpose of evading taxes or used as a device to prevent taxation as in *Helvering v. National Grocery Co.*, 304 U. S. 282, 82 Law Ed. 1346. We are dealing with a corporation which obeys the law by refusing to distribute a dividend because its capital is impaired. We are dealing with a tax measure which imposes a so-called undistributed profits tax irrespective of whether the profits are needed to restore capital or may be used for dividend distribution. Taxes are real things and should be judged by practical standards. It is fiction to call a tax upon that portion of a corporation's profits needed to restore an impaired capital, an *income* tax.

CONCLUSIONS.

A binding contract was in existence between Appellee and the State prior to May 1, 1936. The terms and provisions of that contract included the incorporation laws. Without that inclusion no charter could have been obtained. One of the conditions imposed upon Appellee restricted dividend payments

while a deficit existed. This condition was imposed for reasons of public policy. The credit under Section 26 (c) (1) should be allowed.

If the credit is disallowed, the tax is in reality not on income but on capital and not apportioned. There is discrimination as between corporations prohibited by charter and those prohibited by another type of written contract from distributing dividends. There is coercion, interfering with state regulation of corporations. Thus if the credit is disallowed, the Act is unconstitutional as applied to Appellee.

The decision of the Circuit Court should be affirmed and Appellee should be exonerated from the claimed deficiency of surtax.

Respectfully submitted,

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APPENDIX.

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 14. SURTAX ON UNDISTRIBUTED PROFITS.

(*a*) *Definitions.*—As used in this title—

* * * * * * *

(2) The term "undistributed net income" means the adjusted net income minus the sum of the dividends paid credit provided in section 27 and the credit provided in section 26 (c), relating to contracts restricting dividends.

* * * * * * *

(U. S. C. Supp. IV, Title 26, Sec. 13a.)

SEC. 26. CREDITS OF CORPORATIONS.

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

* * * * * * *

(*c*) *Contracts Restricting Payment of Dividends.*

(1) *Prohibition on payment of dividends.*—An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. If a corporation would be entitled to a credit under this paragraph because of a contract provision and also to one or more credits because of other contract provisions, only the largest of such credits shall be allowed, and for such purpose if two or more credits are equal in amount only one shall be taken into account.

Session Law 1933, p. 787 Sec. 25, Laws of the State of Washington, Rem. Rev. Stat. 3803-24, Vol 5.

"1. Every corporation shall carry upon its books as a liability the amount of its capital stock as defined in section 3803-1, subdivision 10.

"2. Amounts of surplus arising from an unrealized appreciation or revaluation of fixed assets shall be shown on the books of the corporation as a separate item apart from surplus profits or paid-in surplus.

"3. In computing the aggregate of the assets of the corporation the Board of Directors shall determine and make proper allowance for depreciation and depletion sustained, and losses of every character. Deferred assets and prepaid expenses shall be written off, at least annually in proportion to their use as may be determined by the Board of Directors.

"4. *No corporation shall pay dividends.*

"(a). In cash or property, *except from the surplus of the aggregate of its assets over the aggregate of its liabilities, including in the latter the amount of its capital stock,* after deducting from such aggregate of its assets the amount by which such aggregate was increased by unrealized depreciation in value or revaluation of fixed assets;

"(b). In shares of the corporation, *except from the surplus of the aggregate of its assets over the aggregate of its liabilities,* including in the latter the amount of its capital stock.

"5. Cash dividends shall not be paid out of surplus due to or arising from

"(a) Any profit on treasury shares before resale; or

"(b) Any unrealized profits due to increase in valuation of inventory before sale; or

"(c) The unaccrued portion of unrealized profits on notes, bonds or obligations for the payment of money purchased or acquired at a discount, unless such notes, bonds, or obligations are readily marketable, in which case they may be taken at their actual market value; or

"(d) The unaccrued or unearned portion of any unrealized profit in any form whatever whether in form of notes, bonds, obligations for the payment of money, instalment sales, credits or otherwise * * * "

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Session Laws, 1933, p. 787, Sect. 25, Rem. Rev. Stat. 3803-25.

"If any dividend be paid in violation of Section 3803-24, or if any other unlawful distribution, payment or return of assets be made to shareholders,

"1. The directors who knowingly, or without making reasonable inquiry, voted in favor thereof shall be jointly and severally liable to the corporation in an amount equal to the amount of the dividend so paid and the distribution, payment or return of assets so made;

"2. Every shareholder who receives any such dividend or any such distribution, payment or return of assets, shall in the following instances be individually liable *to the corporation,* in an amount equal to the amount so received by him:

"(a) When no director is liable to the corporation as provided in Subdivision 1 of this section, or

"(b) To the extent that the corporation is unable to obtain satisfaction after judgment is recovered against directors upon the liability imposed by subdivision 1 of this section * * * "

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Rem. Rev. Stat. 3823, Session Laws of 1923, p. 543, *Sec. 2.*

"It shall not be lawful for the trustees to make any dividend except from the net profits arising from the business of the corporation, nor divide, withdraw, or in any way pay to the stockholders, or any of them, any part of the capital stock of the company unless in the manner prescribed in this chapter, or the articles of incorporation or by-laws; and in case of any violation of the provisions of this section, the trustees, under whose administration the same may have happened, except those who may have caused their dissent therefrom to be entered at large on the minutes of the board of trustees at the time, or were not present when the same did happen, shall, in their individual or private capacities, be jointly or severally liable to the corporation and the creditors thereof in the event of the dissolution, to the full amount so divided, or reduced, or paid out * * * ."

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SUPREME COURT OF THE UNITED STATES.

No. 121.—October Term, 1940.

Guy T. Helvering, Commissioner of Internal Revenue, Petitioner, *vs.* Northwest Steel Rolling Mills, Inc.	On Writ of Certiorari to the United States Circuit Court of Appeals for the Ninth Circuit.

[November 12, 1940.]

Mr. Justice Black delivered the opinion of the Court.

Respondent corporation, because of a previously existing deficit, was prohibited by state law[1] from distributing as dividends its profits earned in 1936. Notwithstanding this state prohibition, the Commissioner held respondent liable under the 1936 Revenue Act[2] for surtax on undistributed profits. The Board of Tax Appeals sustained the Commissioner;[3] the Circuit Court of Appeals reversed.[4] On a similar state of facts the Court of Appeals for the Eighth Circuit held undistributed profits taxable.[5] We granted certiorari in both cases to resolve this conflict.[6]

Section 14 of the 1936 Act imposed a general surtax on corporate profits earned but not distributed as dividends during the tax year. Section 26(c)(1) of the Act relieved from such surtax all undistributed profits which the corporation could not distribute as dividends "without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends."

The only "written contract executed by the corporation" upon which respondent relies for its claimed exemption is its corporate

1 "No corporation shall pay dividends . . . except from the surplus of the aggregate of its assets over the aggregate of its liabilities. . . ." Wash. Rev. Stat. Ann. (Remington, 1932) tit. 25, section 3803-24.

2 49 Stat. 1648, 1655.

3 The memorandum opinion of the Board is not officially reported; the Board relied on its earlier opinion in Crane-Johnson Co. *v.* Commissioner, 38 B. T. A. 1355.

4 110 F. (2d) 286.

5 Crane-Johnson Co. *v.* Commissioner, 105 F. (2d) 740.

6 309 U. S. 692; 311 U. S. —.

charter, granted by the state of Washington. Upon the premises that respondent's Washington charter was a written contract, and that the Washington laws prohibiting dividend payments were by operation of law a part of that contract, the court below concluded that the taxpayer had satisfied the requirements of section 26(c)(1).

We must therefore decide whether section 26(c)(1) authorized a credit or deduction to corporations prohibited by state law from distributing dividends. And respondent strongly urges that the Act, if construed to deny such credit, is unconstitutional.

First. It is material that we are dealing here with a generally imposed surtax upon the undistributed net income of corporations, and that respondent's claim is for a credit in the nature of a specially permitted deduction. It has been said many times that provisions granting special tax exemptions are to be strictly construed.[7]

Measured by this sound standard it is probably not necessary to go beyond the plain words of section 26(c)(1) in search of the legislative meaning. Certainly, at first blush, few would suppose that when Congress granted a special exemption to corporations whose dividend payments were prohibited by executed written contracts, it thereby intended to grant an exemption to corporations whose dividend payments were prohibited by state law. The natural impression conveyed by the words "written contract executed by the corporation" is that an explicit understanding has been reached, reduced to writing, signed and delivered. True, obligations not set out at length in a written contract may be incorporated by specific reference, or even by implication. But Congress indicated that any exempted prohibition against dividend payments must be expressly written in the executed contract. It did this by adding a precautionary clause that the granted credit can only result from a provision which "expressly deals with the payment of dividends."

That the language used in section 26(c)(1) does not authorize a credit for statutorily prohibited dividends is further supported by a consideration of section 26(c)(2). By this section, a credit is allowed to corporations contractually obligated to set earnings aside for the payment of debts.[8] That this section referred to

[7] E. g., Deputy *v.* du Pont, 308 U. S. 488, 493; White *v.* United States, 305 U. S. 281, 292; New Colonial Ice Co., Inc. *v.* Helvering, 292 U. S. 435, 440.

routine contracts dealing with ordinary debts and not to statutory obligations is obvious—yet the words used to indicate that the section had reference only to a "written contract executed by the corporation" are identical with those used in section 26 (c)(1). There is no reason to believe that Congress intended that a broader meaning be attached to these words as used in section 26(c)(1) than attached to them under the necessary limitations of 26(c)(2).

Respondent urges that the legislative history of section 26(c)(1) supports its contention. But, on the contrary, that history points in the other direction. The original House Bill contained separate relief provisions (1) for deficit corporations such as respondent; (2) for corporations contractually obligated to pay debts; and (3) for corporations contractually prohibited from paying dividends.[9] The Senate Finance Committee struck out all three of these House provisions, but substituted an equivalent for the third.[10] An amendment from the Senate floor restored an equivalent of the second.[11] But the bill as finally passed contained no express relief provision relating to deficit corporations.

It is true, as respondent contends, that a charter has been judicially considered to be a contract insofar as it grants rights, properties, privileges and franchises.[12] To this extent it has been said that an Act of Incorporation is a contract between the state and the stockholders.[13] But it does not follow that Congress intended to include corporate charters and related state laws in the cautiously limited area permissible for tax credits and deductions under this section. Nor have the courts considered that all the provisions of laws providing for the grant of corporate franchises are necessarily contractual in their nature. The same legislative Act is a law as

[8] 49 Stat. 1664. The credit allowed is "An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside."

[9] H. R. 12395, 74th Cong., 2d Sess., sections 14, 15, and 16; see H. Rep. No. 2475, 74th Cong., 2d Sess., pp. 8-9.

[10] See S. Rep. No. 2156, 74th Cong., 2d Sess., pp. 12-13, 15-16.

[11] 80 Cong. Rec. 9071, 74th Cong., 2d Sess.

[12] Trustees of Dartmouth College *v.* Woodward, 4 Wheat. 518; Home Building & Loan Ass'n *v.* Blaisdell, 290 U. S. 398, 429.

[13] Chenango Bridge Co. *v.* Binghamton Bridge Co., 3 Wall. 51, 73.

well as a grant, and this Court has held that the same legislative enactment may be both a contract—which cannot be impaired—and a law, subject to repeal, modification, alteration, or amendment within the general legislative powers.[14] Respondent's chief reliance is upon that charter provision which required that it conform to the existing and future laws of Washington. But that provision is not a grant and is not a contract. With or without such a charter provision, it was the duty of the corporation to conform to valid Washington statutes. The corporation was subject to the law of Washington; it could not rise above it. A corporate charter to operate a particular business in a particular manner does not deprive the state of its inherent power of legislation touching corporate activities. And the grant of a franchise does not exempt the corporation from the requirement that it obey state legislation validly adopted in the interests of the public welfare.[15] It cannot be said, therefore, that the charter provision that the corporation should obey Washington law, including the statutory prohibition against distributing dividends, was a provision of a written contract executed by respondent. More, the Constitution of the State of Washington under which the general corporation laws were enacted provides that "All laws relating to corporations may be altered, amended, or repealed by the legislature at any time, and all corporations doing business in this state may, as to such business, be regulated, limited, or restrained by law."[16] It is clear, therefore, that what prohibited respondent from distributing dividends was not the provision of an executed written contract expressly dealing with the payment of dividends. On the contrary, what prohibited respondent from paying dividends was a valid law of the State of Washington.[17]

Second. Respondent contends that the tax statute, as construed, offends the Fifth, Tenth and Sixteenth Amendments. None of those contentions is valid.[18]

It is argued that the Act offends the Due Process clause of the Fifth Amendment because it permits credits or deductions in the

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[14] Oregon & California Railroad Co. *v.* United States, 238 U. S. 393, 427.

[15] Hammond Packing Co. *v.* Arkansas, 212 U. S. 322, 345.

[16] Washington Constitution, Article 12, § 1.

[17] Respondent contended that the stock certificates satisfied the statutory requisites even if the charter did not; but what we have here said with respect to the charter applies equally to the certificates.

[18] Cf. Helvering *v.* National Grocery Co., 304 U. S. 282.

case of corporations restrained from a distribution of dividends under a given type of written contract, while not permitting any credit or deduction to corporations restrained from distribution by oral contracts or by the laws of a state. This contention is without merit. It is not necessary to point out the many obvious reasons that might underlie the distinctions here drawn in granting special deductions from a generally imposed tax.

Respondent also urges that the tax as applied to it amounts to a confiscation of its property without Due Process of law because the tax is imposed, not on income, but only on undistributed income, and that there can be no undistributed income so long as the corporation has an existing deficit. But the surtax here is imposed upon the undistributed net income of the corporation "for each taxable year." It is true that the surtax is imposed upon the annual income only if it is not distributed, but this does not serve to make it anything other than a true tax on income within the meaning of the Sixteenth Amendment. Nor is it true, as respondent urges, that because there might be an impairment of the capital stock, the tax on the current annual profit would be the equivalent of a tax upon capital. Whether there was an impairment of the capital stock or not, the tax here under consideration was imposed on profits earned during a definite period—a tax year—and therefore on profits constituting income within the meaning of the Sixteenth Amendment.

It is contended that the statute as here applied violates the Tenth Amendment because it interferes with the authority of the states to prescribe the powers of corporations and the conditions under which their powers may be exercised. But the statute in no way limits the powers of the corporation. It imposes a tax as authorized by the Sixteenth Amendment and does not infringe upon the powers reserved to the state by the Tenth Amendment.[19] The court below was in error; its judgment is reversed and the cause is remanded with directions to affirm the judgment of the Board of Tax Appeals.

Reversed.

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[19] Helvering *v.* National Grocery Co., *supra*, at 286-287. And cf. Florida *v.* Mellon, 273 U. S. 12, 17: "Congress cannot accommodate its legislation to the conflicting or dissimilar laws of the several states nor control the diverse conditions to be found in the various states which necessarily work unlike results from the enforcement of the same tax."